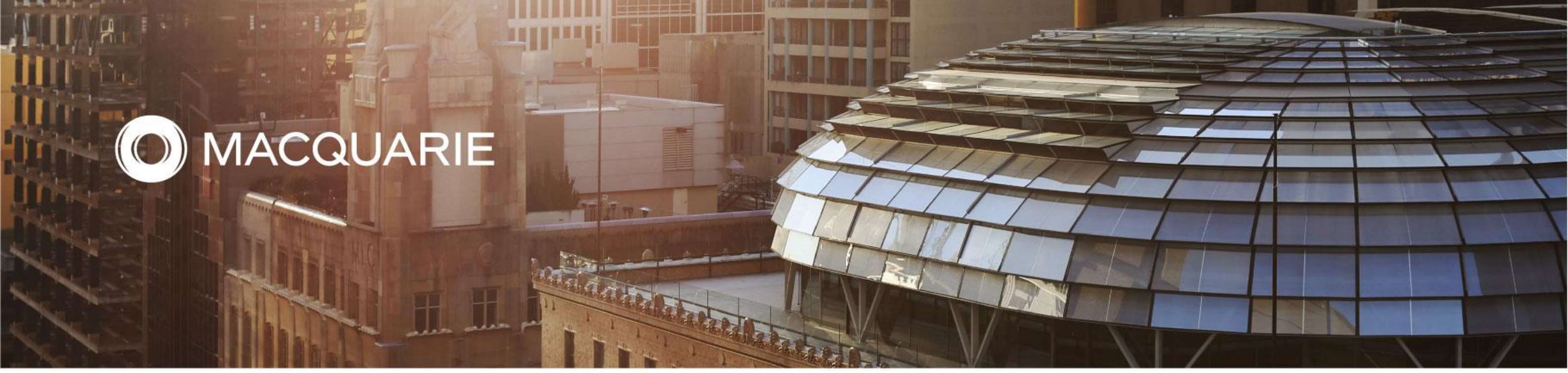


Investment Strategy Update #99

Positioning for higher inflation, rates and volatility, but not recession

- In this note we address:

1. **What is driving current weakness?** Inflation pressures have pushed central banks into an earlier than expected and more aggressive policy tightening cycle. This has pushed bond yields sharply higher and driven a rapid deceleration in global liquidity conditions. As financial conditions have tightened, valuations and support for the most liquidity sensitive areas of the equity market have undergone a substantial valuation contraction. This has been concentrated in expensively priced assets from tech to crypto to SPACs. More recently, fears of an overtightening by central banks is stoking recession (growth and earnings) concerns.

2. **What do we need to see for a bottom in risk assets / to in bond yields?** We see a number of factors as being required to drive a sustainable bottom in equities and a stabilization in bond yields / credit spreads. This includes: 1) a moderation in inflation pressures (and/or some evidence that the breadth of price increases is lessening); 2) A more dovish shift in central bank rhetoric which in turn will help alleviate overtightening fears); 3) An end to the conflict in Ukraine and/or a more aggressive pro-growth policy push by the Chinese Administration; and 4) Risk assets becoming outright cheap. While equity markets have corrected substantially, this has been concentrated in growth stocks. Markets would need to trade below LTA valuations for sufficient downside cushion in the absence of other improvements.

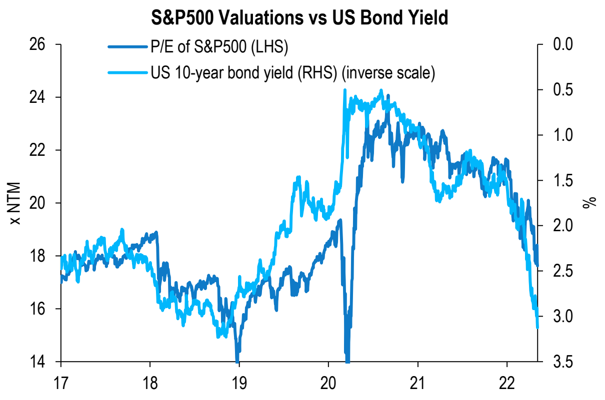
3. **How we want to position?** We have been negative sovereign bonds, winding back our equity exposure and lifting our alternative and real asset exposure for over a year. However, even this cautious (and stay patient) stance has not been sufficient to offset weakness across both bonds and equities and accept that unless we see some inflation and rate stabilization that equities are unlikely to find a floor. But we are not positioning for recession and the valuation correction has now gone a long way if not at its conclusion. We recommend a small overweight to equities (via the US and Australia) and expect growth stocks can rebound when the outlook begins to clear. We expect ongoing volatility and prefer diversifying strategies including long/short equities and alternatives. While there is now talk of extending duration in fixed income portfolios, we remain cautious for the time being and prefer to keep our broad underweight across credit and sovereigns until we see our markers emerge.

1. What is driving current weakness?

Inflation, central bank policy tightening and a broad based reduction in global liquidity conditions are the primary concerns driving higher yields and equity market weakness.

On top of the dramatic repricing of policy rates and unwind of quantitative easing, the risk of a policy mistake is now also rising. Recession fears from overtightening have been further compounded by China lockdowns and the conflict in Ukraine, although we view inflation as the root cause of the recent selloff. Bond yields have risen dramatically and when liquidity and momentum has helped push valuations to extreme levels, the unwind can be disorderly as we have seen in recent months.

Higher rates have compressed valuations

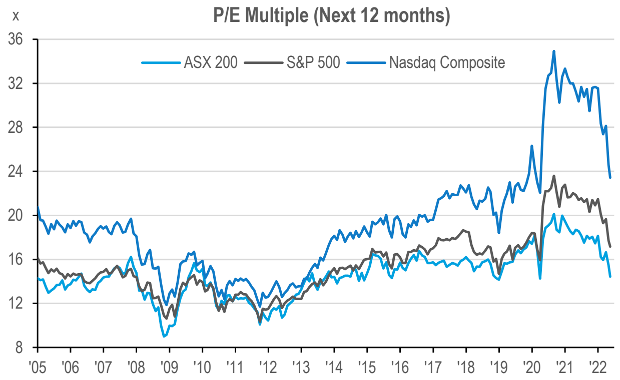


Source: FactSet, MWM Research, May 2022

History shows that rate tightening cycles are almost always accompanied by slower economic growth and/or recession (the latter in around two-thirds of instances). But we are not prepared to bet on a policy mistake despite how difficult it will be for central banks (and in particular the Fed) to thread the needle on policy tightening. We prefer to wait to see how the growth implications play out. Instead of assuming recession is the outcome, we are positioning for co-ordinated monetary and fiscal policy tightening that drives a sharp growth (and inflation) slowdown. Whether that ends in recession is a risk, but not a certainty.

Valuations have compressed across the board but have been more acute in high-multiple tech stocks. We don't view current weakness as similar to the 1999/2000 'tech wreck' (where bubble valuations had little earnings support), but rather a selloff that has been concentrated in tech because its valuations were high. Other high valuation / speculative assets have been similarly hit including cryptos, non-tech growth stocks, SPACs and IPOs. All things equal, the higher the valuation, the more vulnerable the valuation has been to higher interest rates.

Higher rates have compressed valuations



Source: FactSet, MWM Research, May 2022

2. What we need to see for an equity bottom / bond yield peak

We think several markers are needed to drive a stabilization in bond yields and a sustainable floor in the equity market. Without these, and while we think a lot of the damage has already been done to bonds and risk assets, we are likely to see extreme volatility with inflation disappointments pushing bond yields higher and equities lower and vis-à-vis until there is some data consistency to determine the direction of yields.

1) **Evidence of a sustainable decline in the level and breadth of inflation prints.** Inflation has been a key driver of bond yields and central bank rate expectations which has flowed through to tighter financial conditions via the cost and availability of credit. Removing the backstop of policy support has pushed discount rates and volatility higher. An easing of inflation prints or evidence that the breadth of price pressures are moderating should see bond yields consolidate and provide the confidence for investors to re-enter the hardest hit areas of the market.

2) **Central banks turning more dovish.** There is a growing risk that central banks will need to overtighten in order to bring inflation back under control. The idea that central banks are prepared to sacrifice growth for inflation is now adding to the valuation compression that is buffeting risk assets and a large dispersion in forecasts for where peak rates may lie. We think a more dovish turn by central banks via acknowledging that rate expectations are overly aggressive and/or that they will not blindly sacrifice growth for inflation will provide a significant boost for sentiment and lower the risk of a policy mistake.

3) **An end to the conflict in Ukraine and/or more aggressive Chinese policy support.** While the war has now slipped down the pecking order in terms of risks to the outlook, we think its impact on energy and food prices remains significant. Similarly, the growth and supply chain implications of China's zero tolerance COVID policies are significant for the global outlook even if is impacts are less direct. Both would provide a solid tailwind for expectations around inflation (lower) and growth (higher) if we were to see some positive developments emerge.

4) **Valuations become outright cheap (usually measures as trading below long term averages). Equity markets could become outright cheap.** MSCI AC World currently trades on a ~14.6x P/E, towards the lower end of its 14-16x range through 2014-2019 and well below its 2020 peak of 20x. Many are looking for a bout of 'capitulation selling' to signify an exhaustion of sellers. Arguably, we have already seen this in the higher-beta areas such as tech stocks, EMs and crypto. The 4Q18 selloff saw valuations bottom out at ~13x which isn't too far off current levels while previous lows of ~10x are unlikely outside of a recession.

Higher rates have compressed valuations

P/E multiple (next 12 months)				
Index	5yr avg	5yr max	Current	% from max
NASDAQ Composite	25.8	35.7	23.4	-34.4%
S&P 500	19.0	24.1	17.2	-28.7%
S&P ASX 200	16.9	20.5	15.7	-23.7%
S&P ASX 200 - Info Tech	47.7	99.9	46.1	-53.8%
S&P ASX Small Ordinaries	18.1	22.3	15.5	-30.3%

Source: FactSet, MWM Research, May 2022

3. How we want to position

We have been reducing risk within portfolios since late last year. We have run underweights to government bonds / credit, overweighted alternatives, raised cash and preferred the low-beta areas of equities. However, even this cautious (and stay patient) stance has not been sufficient to offset weakness across both bonds and equities and accept that unless we see some inflation and rate stabilization that equities are unlikely to find a floor.

We are currently positioned for ongoing volatility, elevated inflation and rising rates rather than economic recession. We expect inflation and rates to decline through 2H, but it appears this might be relatively gradual.

Valuations have already corrected a long way. The S&P 500 has corrected ~18% from its recent peak (the average decline during a recession is around 22-24%) and should be well supported once investors can be confident inflation pressures are easing and the Fed will not overtighten and engineer a recession. In Australia – the correction has been relatively minor at ~7%, so there is some catch up risk, but it is important to recognise ASX earnings have been very strong YTD which has partially offset valuation compression.

Our key recommendations are:

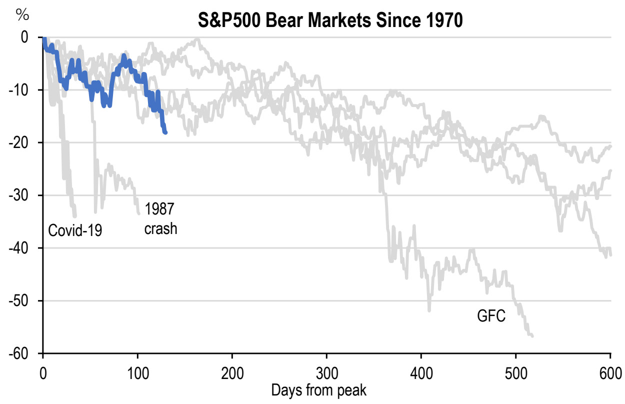
1) **Maintain a small overweight to equities.** The bull market is getting old but is not yet dead. Valuations have already seen a sharp correction and should provide a solid base for performance once the outlook clears.

2) **Overweight long / short strategies / volatile strategies.** Inflation and rates are likely to remain volatile and could continue to surprise to the upside before easing. As such we are tactically cautious and recommend staying positioned for ongoing volatility via long/short funds which benefit from market dislocation and the more challenging earnings environment.

3) **Overweight quality growth.** We prefer areas of strong structural growth over broad economy wide growth while high-quality companies should be well positioned to pass through costs. Investors who have a medium to long term outlook should maintain a bias towards growth at a reasonable price (GARP) strategies with the option of supplementing these with tactical allocations to value strategies, but not the other way around.

4) **Stay diversified.** In a more uncertain, lower return backdrop, where equities and bonds are showing a high degree of correlation, portfolios should remain diversified with exposures into alternatives and private markets as a key ballast.

The S&P 500 is not yet in a bear market



Source: FactSet, MWM Research, May 2022

Macquarie WM Investment Strategy Team

The report was finalised on 16 May 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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